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REPLY TO RESPONDENT'S MEMORANDUM IN OPPOSITION

In The

SUPREME COURT OF THE UNITED STATES

October Term, 1962

No. **443**

RUFUS F. TURNER and
MARGUERITE H. TURNER
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

FORTESCUE W. HOPKINS
H. CLYDE PEARSON
509 Mountain Trust Building
Roanoke, Virginia
Attorneys for Petitioners

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The respondent has completely misstated the principal issue in this proceeding as evidenced by his statement (Mem.-3) that "Petitioner contends that the Notice of Indebtedness was a "security" within the meaning of Section 351 (Pet. 10-17)". The petitioner does not now (Pet. 10-17), and did not in his briefs filed in the courts below contend that the Notice of Indebtedness was a "security" nor does he contend that the long term debenture bond received on January 14, 1958 was a security (Pet. 19). In his petition, as amended (Appendix, infra), filed with the Tax

Court and in his briefs filed with the Tax Court and the Court of Appeals, the petitioners' contention, *inter alia*, has consistently been, as set forth and recognized in the respondent's brief (p. 18) filed with the Court of Appeals:

> "The taxpayer maintains that the 'Notice of Indebtedness' was substantially 'stock' and consequently no gain is to be recognized under Section 351(a). In this argument he contends that investment in the corporation represented by the 'Notice of Indebtedness' was essentially 'equity capital' like a stock interest".

It is obvious that the respondent is well aware of the nature of the issue here presented and the disposition that the Court of Appeals should have made as the respondent also stated in his brief before the Court of Appeals (p. 22, fn. 4):

> "In the event the Court of Appeals determines that the Tax Court should have made more specific findings on the equity v. debt issue, the case should, of course, be remanded with instructions. *Gilbert* v. *Commissioner*, 248 F. 2d 399 (C. A. 2d)."

Moreover, there is nothing in the argument (or cases relied upon therein) set forth in the Petition (10-17) that could possibly be construed to indicate that petitioners' contention was that the "Notice of Indebtedness", itself, was a "security" (and not "stock").

From the foregoing, it is reasonable to infer that the respondent has attempted to mislead this Court as to the nature of the issue here presented and, apparently, it has no valid objection or response to petitioners' argument that

the Notice of Indebtedness represents risk capital equivalent to "stock" (Pet. 10-17).

Since respondent's premise as to the issue here involved is in error, it follows that the case of *Pinellas Ice Co.* v. *Commissioner*, 287 U.S. 462, cited by respondent as authority for its position that the "notice" was not a "security" is not relevant to the issue here presented.
tions presented in the courts below is misleading and reflects an attempt to gloss over or ignore the precise questions raised in the courts below (Appendix, infra).

In denying that a taxable incorporation occurred, the following sub-questions were raised by the petition filed in the Tax Court and extensively argued in the courts below (see copy of amended petition, Appendix, *infra*):

1. The Notice of Indebtedness was an equity interest equivalent to stock (App. Par. 4 (f) (Pet. 10-17).

2. The Notice of Indebtedness was an intermediate step and not a concluding step in the incorporation of petitioner's business. (App. Par. 4 (a)) (Pet. 18-19).

3. The petitioners' business had: (a) no good will or (b) no *transferable* good will (App. Par. 4 (d)) (Pet. 19-22).

The respondent's allegation (Mem.-3)[1] as to the ques-

4. If the Notice of Indebtedness was "other property",

[1] "The question presented here is whether both courts below properly sustained the Commissioner's determination that the Notice of Indebtedness was not a 'security' but was 'other property' within the meaning of Section 351 which was taxable to petitioner at its fair market value."

it was not the "equivalent of cash" and therefore not "other property received" within the meaning of Section 351 (b) IRC 1954. (App. Par. 4 (c) & 4 (e)). (Pet. 22-24).

5. The Notice of Indebtedness had (a) no fair market value or (b) a value less than face value. (App. Par. 4 (c)) (Pet. 24-25).

A decision on any one of the foregoing questions in favor of the petitioner would eliminate the deficiency in tax and, contrary to respondent's allegation (Mem.-3), the decisions of other courts conflicting with the opinion of the courts below are (as set forth in the Petition) almost uncountable. The respondent's MEMORANDUM IN OPPOSITION is responsive to only two of the foregoing questions, i.e., "good will" and "step transaction".

GOOD WILL

In the respondent's memorandum (fn. 3, page 4), the respondent alleges that:

> "The contemporaneous conduct and declarations of (petitioners') accountant as the man most familiar with taxpayers' business are certainly substantial evidence to support the court's findings" (Pet. App. 31-32). There is no cause for this Court to make a further review of this factual determination."

As set forth in the Petition (pages 19-21) and on the basis of the *undisputed facts,* the decision of the courts below is clearly in error. Also, the question of the *transferability* of personal good will upon incorporation is a "legal" and not a "factual" question.

The Tax Court found that the Notice of Indebtedness was a concluding and not an intermediate step on the grounds that the notice was a (legally) "enforceable obligation" (Pet. App. 16-17) based upon its misconception of the applicable local law. It also found, contrary to all testimony adduced, that the execution of the long term debenture bond on January 14, 1958, was prompted by the advice of the petitioners' accountant's former supervisor that the Notice of Indebtedness would result in a taxable transaction (Pet. App. 11). In this connection, the statement at Page 2 of the memorandum that: "This transaction occurred a few days after petitioner had been advised by an accountant that the 'Notice of Indebtedness' rendered the transfers to the corporation taxable rather than tax-free (Pet. App. 11). "is not due any great weight for the reason that the accountant who gave the petitioner such advice was not the petitioners' accountant. The petitioners' accountant had considered the transaction to be tax free for the reason that he knew that the petitioner had intended the notice to be merely a temporary memorandum to be later supplanted by a more formal instrument of debt.

The Court of Appeals reviewed these facts in a somewhat different light and rejected the Tax Court's conclusion that the Notice of Indebtedness was an "enforceable obligation" since it was not formally authorized by the corporation (Pet. App. 32) and for reason of the rule of law in Virginia that "an officer cannot legally bind his company in a contract with himself without 'authority' expressly given." 13 Am. Jur. § 932; 4 Michie's Jurisprudence (Va., W. Va.) Corporations § 164.

The Court of Appeals did not completely reject the testi-

mony of the witnesses that a subsequent formal debt instrument was contemplated (Pet. App. 31). Rather, the Court of Appeals held that the issuance of the Notice of Indebtedness interrupted a preconceived plan "with unfortunate tax consequences to Mr. Turner." (Pet. App. 31)

In ignoring the test in step transactions (Pet. 18) which requires that the legal relations created by the first transaction not be fruitless, the Court of Appeals, apparently, relied upon the presumption that the petitioner, as sole stockholder, would not impose any legal defense to the payment of the notice. (Pet. App. 32). This presumption, however, is unwarranted. It has been held that where a corporation is newly formed the *presumption* is that the principal stockholder will not make withdrawals that would endanger the operation of the business or require its liquidation. *Brake & Electric Sales Corp.* v. *U.S.*, 287 F. 2d (C. A. 1, 1961); *Charter Wire, Inc.* v. *U.S.*,—F Supp—(DC Wis. Nov. 17, 1961). Also, the petitioner stated, at the time of incorporation, that he had no intention of paying the notice except out of the profits of the company (Pet. 6).

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

Respectfully submitted.

FORTESCUE W. HOPKINS
H. CLYDE PEARSON
509 Mountain Trust Building
Roanoke, Virginia

Attorneys for Petitioners.

APPENDIX

[Caption Omitted]

MOTION FOR LEAVE TO AMEND PETITION

Come now the petitioners, by their attorney, Fortescue W. Hopkins, and respectfully move the Court for leave to amend their petition as follows.

Petitioners aver (and respondent has so advised petitioners' counsel) that the following amendments will not in any manner delay the hearing in this proceeding scheduled for the calendar of the Tax Court at Greensboro, North Carolina, beginning on September 26, 1960:

(1) The entire paragraph 4 of the Petition heretofore filed is eliminated and the following paragraph 4 is substituted therefor:

"4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in determining that the petitioners, in 1957, received a non-interest bearing note (notice of indebtedness) taxable as a long term capital gain in the amount of $48,893.46. In making this determination, the Commissioner erred in failing to determine that (1) the incorporation of Cash Produce Company, Inc. was a tax-free exchange under the provisions of Section 351, Internal Revenue Code 1954, and (2) the petitioners' receipt in 1958 of a long term debenture bond in the sum

of $48,893.46 was an integral step in the plan of incorporation of the said Cash Produce Company, Inc.

(b) Alternately, the Commissioner erred in determining that the said notice of indebtedness in the amount of $48,893.46 constitutes "other property received" within the meaning of Section 351(b)(1)(B), IRC 1954, and taxable to the petitioners in 1957.

(c) Alternately, if the Court should determine the said notice of indebtedness constitutes "other property received" within the meaning of Section 351(b)(1)(B), IRC 1954, the Commissioner erred in failing to determine that its fair market value was zero or substantially less than $48,893.46 and, therefore, no gain was recognizable to petitioners under the provisions of Section 351(b)(1), IRC 1954.

(d) Alternately, if the Court should determine that the said notice of indebtedness constituted "other property received" within the meaning of Section 351(b)(1)(B) and that it had fair market value, the Commissioner erred in determining that the total fair market value of assets received (notice of indebtedness plus 1,500 shares of stock) exceeded the cost of assets exchanged and that a gain was realized upon the exchange incident to the incorporation of petitioners' business.

(e) Alternately, if the Court should determine that the said notice of indebtedness constitutes "boot" taxable to the petitioners under the provisions of Section 351(b)(1)(B), the Commissioner erred in failing to determine that the said notice of indebtedness was intended merely as evidence of an obligation and not intended in payment thereof and, therefore, the Commissioner erred

in determining that the petitioners' realized taxable gain in the year 1957 evidenced by said notice of indebtedness.

(f) Alternately, the Commissioner erred in failing to determine that the said notice of indebtedness constituted an equity interest equivalent to stock or security and, therefore, erred in failing to determine that the incorporation was tax free under the provisions of Section 351, IRC 1954."

(2) Clause (h) is added to the end of paragraph 5 of the Petition heretofore filed:

"(h) The fair market value of the stock and other property, if any, received by the petitioners upon the incorporation in 1957 did not exceed the cost basis of the assets exchanged therefor ($49,593.46)."

WHEREFORE, it is prayed that this motion be granted and that the petition be amended as indicated above.

(Signed) FORTESCUE W. HOPKINS
Fortescue W. Hopkins
Counsel for Petitioners
509 Mountain Trust Bank Building
Roanoke, Virginia

No objection.

(Signed) HART H. SPIEGEL
HART H. SPIEGEL

PJW

Chief Counsel
Internal Revenue Service
15 Sept. 1960